An opportunity to revisit the board

Japanese companies respond to the new Corporate Governance Code

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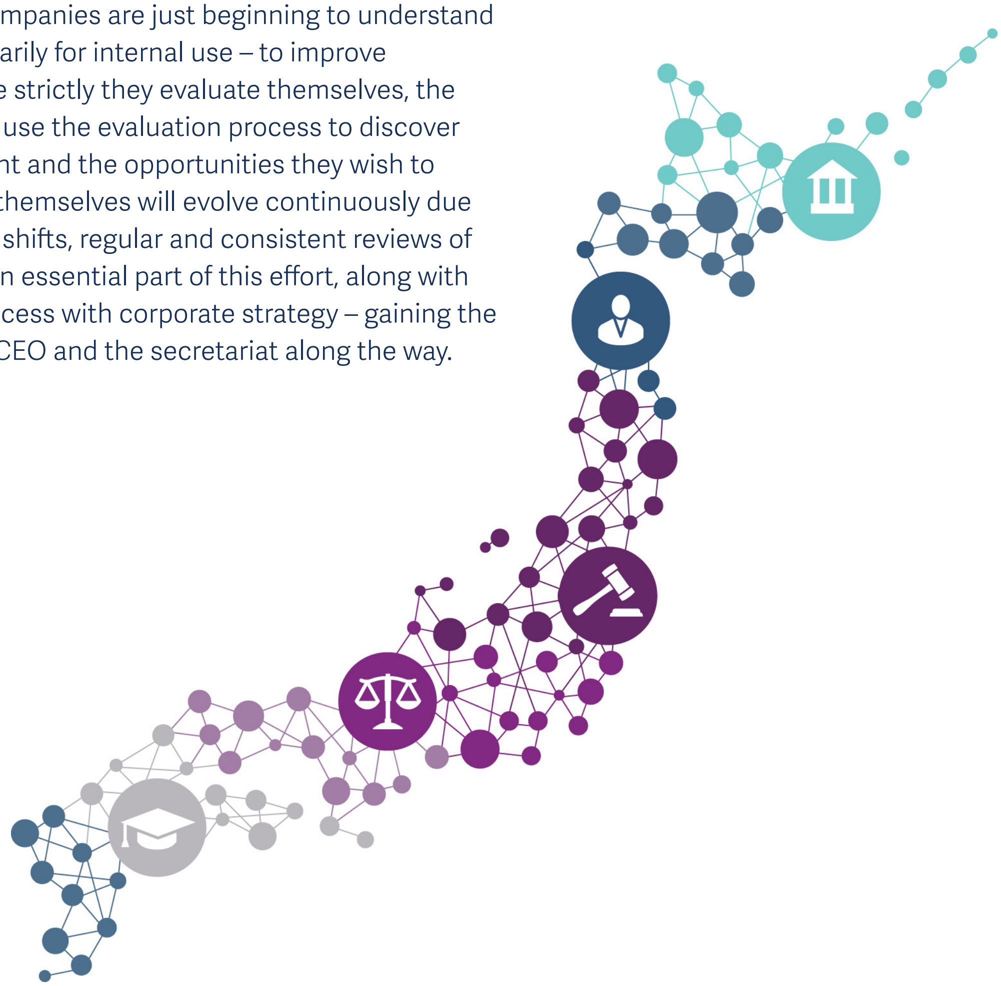
Executive Summary

The introduction of Japan's Corporate Governance Code in late 2015 required Japanese companies to formally evaluate their boards for the first time. Yet many Japanese companies seemed unprepared to contemplate what an "ideal" board might be – making it difficult to evaluate their own organization. In addition, the culture of constructive feedback has not yet taken root in Japan as it has in some other parts of the world, such as the US and the UK, where the great majority of businesses perform routine board evaluations. Perhaps not surprisingly, therefore, there has been some reluctance by Japanese companies to review and rate their board's performance and composition.

Nonetheless, many companies submitted a limited questionnaire to their boards, while some brought in third parties to perform external evaluations. These companies appear to have derived great value from the process, uncovering a number of challenges facing their boards for the first time. These challenges included a need for more substantive strategy discussions, greater board diversity, more involvement in succession planning and increased information sharing with outside directors.

In other parts of the world, such as the US and the UK, investor demands for stricter and more detailed board evaluations are growing – and in particular for objective, external evaluations every few years. As a result, we believe such evaluations will eventually become the norm in Japan. The sooner that Japanese companies understand and accept the evaluation process, therefore, the better positioned they will be to meet investor demands going forward.

While there is still some confusion around the evaluation process, of course, these are early days. Companies are just beginning to understand that board evaluations are primarily for internal use – to improve governance – and that the more strictly they evaluate themselves, the better. In addition, boards must use the evaluation process to discover the kind of board they really want and the opportunities they wish to seek. Finally, given that boards themselves will evolve continuously due to market, regulatory and other shifts, regular and consistent reviews of the evaluation process will be an essential part of this effort, along with realistic actions to align the process with corporate strategy – gaining the support of the board chair, the CEO and the secretariat along the way.



Board evaluation: Critical points of the Code

Japanese companies, not being accustomed to looking at themselves very objectively, may have met the recent "evaluation of board effectiveness" – which listed companies were required to adopt by Japan's Financial Services Agency (FSA) and the Tokyo Stock Exchange (TSE) under Japan's Corporate Governance Code in 2015 – with a degree of culture shock.

Companies in Japan are required to either "comply" or "explain reasons for non-compliance" with each of the principles of the Code, which consists of 73 principles and serves as a guideline for corporate governance improvement. Among the initial responses to this inaugural effort by Japan to introduce a new governance code, the highest percentage of responses indicating a desire for non-compliance came for the principle that concerned the evaluation of board effectiveness (Supplementary Principle 4.11.3). In other words, Japanese companies in general seem ill-prepared to even consider the concept of an "ideal" board, or how a board ought to be.

Recent responses to the Code in general have varied from company to company. There were some companies that merely focused on complying with as many principles as possible while conducting fairly superficial self-evaluations. Others made a sincere effort to evaluate their boards, utilizing tools that ranged from self-evaluations to in-depth evaluations by outside parties in order to bring about change.

We must bear in mind that Japanese companies' response rates to customer-satisfaction or post-project surveys are traditionally extremely low. The culture of engaging in the provision – or, indeed, the reception – of constructive feedback has not yet taken root. In fact, there is somewhat of an aversion to evaluations on the whole. This is a culture in which the term "evaluation" tends to carry with it a rather weighty judgmental undertone; as a result, many do not understand the intended purpose of the self-evaluation, which is merely to identify areas for improvement.

The effort to assess the state of self-governance is a global trend, and the principle concerning the evaluation of board effectiveness is perhaps the most critical point of the Corporate Governance Code. Yet, perhaps ironically, companies seem to have been most puzzled by this very principle.

What is a board evaluation?

The Code states that the board is responsible for sustainable corporate growth and the increase of corporate value over the mid to long term. Specifically, the board is expected to supervise the management and directors and oversee the performance of corporate executives. The objective of board evaluations, in turn, is to monitor the board's effectiveness in fulfilling these responsibilities.

These board evaluations, which include a company's efforts to enhance corporate governance and identify opportunities for improvement, are considered extremely important in terms of accountability to shareholders.

Looking back at the history of board evaluations, the United States and many European countries began to require or encourage an evaluation of board effectiveness partly in response to a series of corporate scandals in the UK in the late 1980s, as well as accounting fraud and the bankruptcies of Enron and WorldCom in the early 2000s. In Japan, the Corporate Governance Code was formulated as a part of Prime Minister Abe's growth strategy, incorporating board evaluation in a manner similar to the codes of the Organization for Economic Co-operation and Development and of the Financial Reporting Council in the UK.

Approximately 90 percent of listed US and European companies conduct board evaluations. In the UK, in addition to self-evaluation, companies are encouraged to undergo evaluation by an external institution every three years. In the case of global companies, governance reports today are always accompanied by the results of board evaluations and full disclosure of the evaluation process.

The first year for board evaluations in Japan

Among 251 companies listed in the TSE's first and second sections, 63 percent reported at the end of 2015 that they had complied with the principle concerning board evaluation.[1] Given it was the first year for the evaluation, this implementation rate was higher than might have been expected.

According to research in Japan by Russell Reynolds Associates (RRA), many complied with the principle by conducting a self-evaluation. Some companies employed external institutions for support in preparing questionnaires in advance, then distributed these 20- to 30-question lists to their boards, asking that the board members respond. After collecting the responses, their secretariat, board chairperson, legal advisory firm or another external institution analyzed the results and summarized them to create the final evaluation. Within global companies, the number of questions in such questionnaires typically exceeds 60; however, these Japanese companies generally used relatively simplified or shortened versions. After executing their self-evaluations, each company shared the analyzed results with the board and subsequently engaged in discussions that took place in March through May, 2016.

In addition, a very limited number of companies had external evaluations conducted by a professional third-party institution. Such third-party institutions included leadership-assessment consulting firms such as RRA, investor relations companies and the consulting divisions of accounting firms. It may take some time for the use of such external experts to be widely accepted, however, as resistance against the involvement of external experts in board meetings is pervasive in Japanese companies.

The typical first step in such an external evaluation is that of anonymous self-evaluations by board members. Based on an analysis of the results, consultants then conduct an in-depth interview with each member for up to an hour and a half. This type of two-stage process allows for the discovery of any specific issues facing the board. For companies with bodies such as nomination or compensation committees in addition to the board, consultants also conduct interviews with the chairperson of each committee.

In any case, self-evaluation may have been an appropriate choice for the first attempt at board evaluation, given that self-evaluation has the advantages of lower costs and easier evaluation work. Many companies that engaged in self-evaluation now understand the areas of opportunity and improvement for the board. They derived great value from having board discussions about the evaluations; in addition, board members were able to uncover many of the issues and challenges facing their own boards for the first time.

There are some areas in which self-evaluation can come up short vis-à-vis external evaluation, however. For one, it is always difficult to secure objectivity and discipline when board members self-evaluate. For another, we can assume that institutional investors and other stakeholders will increase their interest in board effectiveness in Japan over time; as a result, the quality of these evaluations may be questioned in the near future, given that investors and stakeholders value reliability and objectivity, as well as consistent and continuous efforts. Finally, while disclosure of individual board matters is not required – even in the US and Europe – global trends indicate that stakeholders are increasingly demanding transparency around board evaluations and the evaluation process. As a result, a greater number of multinational Japanese companies will be persuaded to consider the value of external evaluations going forward.

1 Daiwa Institute of Research Ltd. "Evaluation of Directors: Overview and Practical Issues."

Challenges identified during the first year of board evaluations

RRA supported several clients during the board evaluation process by preparing questionnaires for self-evaluation or conducting external evaluations. As a result of these experiences, we have identified several common board issues for Japanese companies, including a need for more sufficient strategy discussions, an evolving board structure, more involvement in succession planning and increased sharing of information with outside directors.

INSUFFICIENT DISCUSSION OF STRATEGIES

All listed companies in Japan naturally engage in the necessary deliberations for the agenda items required by the Companies Act. Under the Code, however, boards are also expected to play a role in setting the broad direction for important strategic issues. At one large transportation equipment manufacturer, for example, the board discusses its long-term strategy several times a year. At a major general insurance company, the board chairman boldly organizes agenda items at his own discretion to ensure that the board spends sufficient time discussing selected strategic matters.

Yet currently, only a few boards of Japanese companies focus on strategic discussions. The primary reason is that many companies now employ a "shikko-yaku system," in which management delegates more decision-making power to the company's shikko-yaku (corporate executive officers) than in the past. Strategically important issues are discussed by shikko-yaku at management meetings; as a result, the board tends to plays a more passive role, meeting primarily to vote.

Nonetheless, thanks to the opportunity offered by the recent Code implementation, when boards and their chairmen do eventually discuss the concept of an "ideal board," the groundwork will already have been laid for the necessity to organize agenda items for board meetings and reform board operations. Furthermore, if a board's participation in strategic issues begins to lead to corporate growth, the "leading company in terms of governance = growing company" equation will already be proven, and a greater number of companies will follow in this direction.

BOARD STRUCTURE

The downsizing of boards has accelerated in the past several years among Japanese companies due to the implementation of the shikko-yaku system. Some Japanese companies still have more board members than typical global companies, however. Rusty O'Kelley III, a member of RRA's CEO and Board Services Practice, states that nine to eleven board members is the ideal number for discussion purposes.

Simultaneously, the call for diversity among board members is growing. According to data from Jiji Press, women accounted for only 4.6 percent of all directors among 500 major listed companies as of July 2016[2]; 88.0 percent of those women were outside directors. While these numbers were certainly an improvement over 2011, when the percentage of female directors was approximately 1.0 percent, gender diversity is still an issue.

In addition, the diversity issue is not limited to gender. If companies are to fully and quickly grasp the nuances of today's increasingly uncertain market environments, they require a forum in which members of different nationalities and age groups can freely exchange opinions. While an increasing number of companies have recently disclosed the rationale behind the appointment of their directors, companies will need more than just formal or superficial explanations if they are to achieve this diversity: They will need full transparency into the data behind each board appointment to ensure that board members' skill sets and experience match the company's strategic direction.

[2] Jiji Press "Majority of Companies appointed female directors and officers (kansayaku and shikkoyaku): 500 major listed companies – research by Jiji Press" (July 21, 2016).

INVOLVEMENT IN SUCCESSION PLANNING

Ensuring transparency in succession planning for the CEO and executive management is, ultimately, an important issue for every board. In reality, however, appointing a successor to the CEO is a prerogative that management likes to keep for itself; as a result, major impediments can stand in the way of making the process more transparent.

When companies decide to form a nomination committee and engage in thorough discussions about succession planning, suitable preparation is required. In most cases, outside directors will lack sufficient information regarding internal candidates for succession. Human resources (HR) or the secretariat will therefore need to work hard to secure the proper data and establish an appropriate process. In addition, the board chairperson and CEO must understand the importance of transparency and the need for a fair succession planning process in order to develop a mechanism to support it.

SHARING OF INFORMATION TO OUTSIDE DIRECTORS

Outside directors may not be able to fulfill their full potential due to lack of knowledge about the company or the relevant industry. However, rapid progress has recently been made in this regard in terms of board members' awareness levels and the provision of information to them by the executive function. Among all the challenges facing boards, therefore, information sharing with outside directors is considered one of the easiest to resolve.

Investor opinions

What do investors in Japan and elsewhere think about the board evaluation mechanism?

According to a 2015 RRA survey conducted in the United States, major proxy advisors such as ISS and Glass Lewis have increasingly called for fairer and stricter board evaluations over the past few years. For example, ISS's QuickScore3.0[3] (2015) requires disclosure not only of overall annual board evaluations, but of evaluations of individual board members and external evaluations, the latter to be conducted every three years. In addition, the UK's Corporate Governance Code, established in 2010, has encouraged companies since the beginning of its implementation to undergo an external evaluation every three years. The United States is moving in that direction as well.

In response to survey questions from RRA, a governance officer of a large asset management company stated that obvious limitations to self-evaluation exist in terms of effectiveness due to relative subjectivity and that companies should enhance the accuracy of their board evaluations by undergoing an external evaluation once every few years. An executive of a major pension fund noted that he reviews all relevant board evaluations and has begun to investigate the fairness and objectivity of those evaluations. And a representative of another asset management company pointed out that an external evaluation is beneficial for the purposes of analyzing a company's own strengths, as well as areas for board improvement.

In terms of what the evaluation process can reveal, investors indicate that succession planning for the CEO and executive management is very important, particularly from the view of corporate risk management. The experience and skill sets of board members also draw a great deal of attention, and there is high demand for boards to engage with stakeholders based on trust.

Board evaluations in Japan have only recently begun, but considering the trends seen in countries such as the UK and the US, stricter and more detailed disclosure will eventually be required in Japan as well.

[3] Institutional Shareholder Services "ISS Governance QuickScore 3.0" (June 2015).

Still early days

Given that 2015 was the first year for board evaluations in Japan, it cannot be said that their significance has been widely recognized to date. According to RRA research, some companies have expressed appreciation for the opportunity, as they found it effective for uncovering issues early on, while others have voiced confusion about how to interpret the contents of the evaluations. Among the companies that conducted self-evaluations utilizing numerical scales, in particular, some have questioned the purpose of the new system, stating that the evaluation criteria were unclear or that they were surprised when they found their score was lower than the average score of other companies.

Going forward, we believe Japanese companies will require greater understanding of the board evaluation objectives, a commitment to in-depth evaluations and continuous efforts for improvement.

GREATER UNDERSTANDING

It is possible we will see the FSA and other relevant government bodies modify the board evaluations under the Code in a way that better suits the specific circumstances of Japanese companies. For example, companies need to understand that the evaluation is not intended for disclosure to outsiders. The evaluation results are intended primarily to help companies review the state of their boards and improve their governance, leading to business growth. If the members of the board conduct the evaluation without knowing the ultimate objectives of this activity, the company could lose any impact that the board evaluation process might offer.

IN-DEPTH EVALUATIONS

Generally speaking, the more strictly companies evaluate themselves, the lower their average score tends to be. But aiming for a high score is not the purpose of the evaluation. Rather, it is essential for boards to use this process to ask themselves what kind of board they should formulate and what opportunities they should seek. From this new perspective, they can consider the form of evaluation system that would best suit the company.

One large electronics manufacturer, for example, has already engaged in extensive discussions as to how to define its ideal board and then evaluated its present state. The fact that this company has meaningfully considered the context of its board evaluation so soon after implementation of the code is impressive and, indeed, hopeful.

CONTINUOUS EFFORTS FOR IMPROVEMENT

Board requirements may evolve continually to reflect market shifts, the company's stage of management, changing environments and regulatory requirements. As a result, we believe the evaluation process should not be relegated to a one-off effort. In fact, to truly increase board effectiveness, we believe companies must (1) fully understand the objective of the evaluation, as noted above, (2) use that understanding to regularly and consistently review how and what the evaluation process should be and (3) work continuously to improve it. Note that, to achieve this, the commitment of both the board chairperson and CEO will be vital, as will close cooperation with the secretariat.

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